Developing Capacity in Transfer Pricing

TASK FORCE ON TAX & DEVELOPMENT
WORK ON TRANSFER PRICING

KEY POINTS

- In the globalised economy, developing countries are opening their borders to trade and investment, exposing them to the risk of tax base erosion and profit shifting (BEPS).
- Relatively few developing countries have fully effective transfer pricing regimes in place to deal with risks arising from BEPS, which denies them essential tax revenue.
- In 2011, the OECD's Task Force on Tax and Development began a programme of support for developing countries seeking to implement or strengthen their transfer pricing rules.
- The programme has already had a significant impact in all countries of operation including the introduction of transfer pricing rules aligned with international standards, setting up of specialist units to carry out the transfer pricing work and increased revenues from transfer pricing audits.
- The Programme is achieving significant results and there are opportunities to further scale up its work in 2016 and beyond.

THE TASK FORCE ON TAX AND DEVELOPMENT

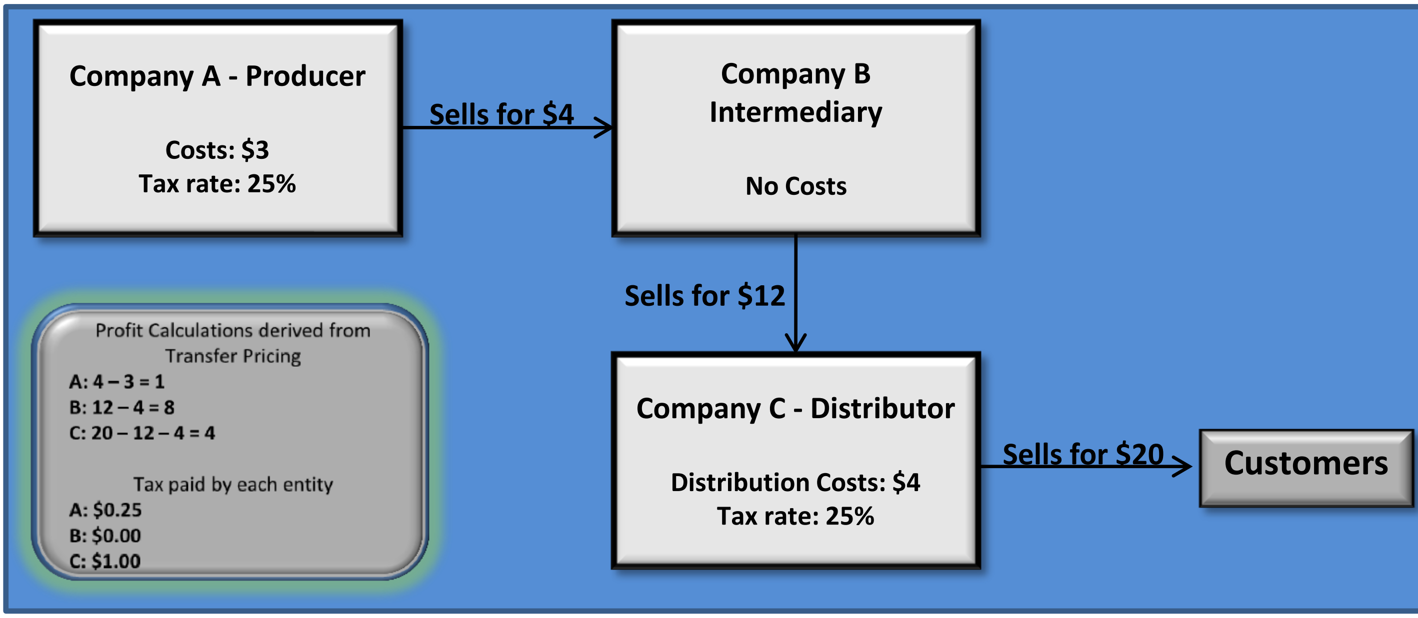
In partnership with the European Commission and World Bank Group, the Task Force on Tax and Development has developed a highly successful Transfer Pricing assistance programme in developing countries.

1. Why is transfer pricing important for developing countries?

In the globalised economy, developing countries are increasingly opening their borders to international trade and investment. Much of this trade is conducted by multinational enterprises (MNEs), and it is estimated that as much as 2/3 of all cross-border business transactions take place between companies belonging to the same group. Such cross-border trade and investment is vital to economic development. But it is essential, also, that developing countries are able to collect tax on the profits that multinational enterprises earn in their countries and do so in a way that does not discourage or distort international trade and investment.

When members of multinational groups of companies undertake transactions with each other (e.g. purchases of inputs, transfers of assets), one member of the MNE charges a price to another member (i.e. the "transfer price"), which is reflected in their accounts and forms the basis for the computation of their accounting and taxable profits. The transfer prices used by multinational enterprises influence the amount of profits that they report (and pay tax on) in each country in which they operate. An example of a transfer pricing transaction between companies belonging to the same MNE and operating in three different jurisdictions is illustrated in figure 1.

Figure 1: Transfer pricing between related parties of the same MNE



For purposes of this example, the intermediary company B (which buys goods from A for $4 and sells them to C for $12) generates significant profit despite carrying on no identifiable economic activity, nor incurring any cost. In this case, the intermediary is located in a no-tax jurisdiction and does not incur tax on this profit. Transfer pricing rules raise the question as to whether an "arm's length" price has been set between the producing, intermediary and selling companies. If not, the governments of either or both of the producing and selling companies may lose out on significant potential revenues.

It should be stressed that transfer pricing is a legitimate and necessary feature of the commercial activities of multinational enterprises, and far from all transfer pricing involves artificial profit shifting such as that illustrated in the example above. However, multinational enterprises can use their transfer pricing as a means of reducing their global tax bill by shifting profit from normal tax-rate counties to low tax-rate countries. This is an issue faced by developing and developed countries alike.

When transfer pricing is used by multinational enterprises to artificially shift profit out of a country, it, first and foremost, denies the country of essential tax revenues. But it can also have much wider implications: tax avoidance by high profile corporate taxpayers will be perceived as "unfair" by citizens, and may undermine the legitimacy and credibility of the tax system, thus discouraging compliance among all taxpayers.

The lessons learned through working intensively on transfer pricing in developing countries are constantly being fed back into the OECD's standard-setting process, to ensure that the developing country perspective is consistently considered in the development of standards and guidance on transfer pricing. This has also provided opportunities for developing countries to have a voice in the OECD's work on BEPS. Base erosion constitutes a serious risk to tax revenues, tax sovereignty and tax fairness for OECD member countries and non-members alike and the G20 has asked the OECD to take forward work on BEPS and advice on how the international tax system can evolve so as to address the challenges.

2. Transfer pricing rules in developing countries

Most OECD and many non-OECD countries have introduced transfer pricing rules into their tax legislation. They have done this in order to ensure that the profits reported by MNEs in their jurisdictions are computed in line with internationally accepted principles, and to counter any inappropriate or abusive transfer pricing by MNEs. In most countries that have transfer pricing rules, the benchmark adopted is the "*arm's length principle*". The arm's length principle requires that transfer pricing between associated enterprises should be the same as if the two companies involved in the transaction were two unrelated parties negotiating in the market, rather than part of the same corporate structure.

Relatively few developing countries have fully effective transfer pricing regimes in place. Many developing countries that have legislation in place often lack the administrative, technical and auditing capacity to conduct effective and efficient audits.

3. Transfer Pricing Programme of the Task Force on Tax and Development

In 2011, the OECD's Task Force on Tax and Development[1] began a programme of support for developing countries seeking to implement or strengthen their transfer pricing rules. The work has assisted countries putting in place measures designed to protect their tax bases, supporting efforts towards a transparent and predictable investment climate through the introduction of rules that create certainty and consistency for business. Support initiatives have been put in place in Botswana, Cambodia, Colombia, Ethiopia, Ghana, Jamaica, Kenya, Malawi, Morocco, Peru, Rwanda, Sri Lanka, Tunisia, Vietnam, Zambia and Zimbabwe. A regional project is underway in the Economic Community of West African States (ECOWAS) region (including Nigeria and Senegal).

A key feature of these demand-led programmes is co-operation between the international agencies involved in their delivery. The OECD, European Commission and World Bank Group have been working together in different projects ensuring coherent and co-ordinated support. The programme also works closely with other partners such as GIZ, SECO and Tax Administrations/Ministries of Finance of developed countries. This ensures that work in this area supports wider financial governance reform and country-owned approaches to development.

This work is also closely aligned with existing country tax reform programmes. Additional World Bank Group projects also benefit, as required, from technical input by the OECD's Tax and Development Programme, particularly by the development of tools, guidance and training materials to assist countries in the practical application of their transfer pricing rules.

4. Transfer Pricing Programme's results to date

The programme has already had a significant impact in all countries of operation.

In Colombia, after the three-year Programme delivered with the World Bank Group and the European Commission, transfer pricing adjustments made as a result of audits of multinational enterprises increased revenues ten-fold from US$3.3m in 2011 to over US$33m in 2014[2]. The Colombian administration states this has been possible because of the practical advice provided by the Tax and Development Programme.

Additionally, Colombia has improved transfer pricing primary and secondary legislation which is aligned with international standards. The Programme provided significant input and advice to Colombia on the drafting of the new legislation. Currently, the Programme is providing assistance to Colombia to strengthen its Advanced Pricing Agreement (APA) programme creating a more certain and transparent investment climate.

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1 The OECD's Task Force on Tax and Development brings together all major stakeholders on tax and development, including representatives from developed and developing countries, international organisations, business, NGOs. It is co-chaired by senior officials from an OECD and a non-OECD country, and is supported by a Secretariat - incorporating extensive government transfer pricing experience – managed jointly by the OECD's Centre for Tax Policy and Administration and Development Coordination Directorate, with staffing and other costs met by the OECD and donor contributions.

2 Figures provided by the Colombian Tax Administration, February 2015.

In **Kenya**, where the Programme is working closely with World Bank Group, the tax administration in 2012 embarked on a significant training programme for its staff on advanced transfer pricing issues. This initiative followed advice from the Tax and Development Programme, which is providing support in developing and delivering the training programme. The capacity building programme is specifically tailored to Kenya's needs and auditors' level of knowledge.

This skills building programme has resulted in more efficient work by the Kenyan Revenue Authority (KRA) resulting in an increase in the number of audit cases completed, revenue collected, and number of cases going to dispute resolution. Revenue collection from transfer pricing audits has doubled from US$52m for year ended 30 June 2012 to US$107m for year ended 30 June 2014. The Programme is now assisting KRA introduce an APA programme creating a more certain and transparent investment climate.

In **Vietnam**, where the Programme is working closely with the EU and World Bank Group, the tax administration has significantly increased its capacity to enforce its transfer pricing rules, resulting in an increase in the number of audits conducted by the tax administration from 1 audit in 2012 to 40 audits in 2013, giving rise to transfer pricing adjustments of US$110m by the end of 2013. Vietnam's tax administration records the completion of over a hundred audits in 2014 that resulted in revenue collection of US$40m. The programme has also provided support on organizational changes in the tax administration, and policy issues relating to legislation, APAs, safe harbours and thin capitalization.

In **Zambia** the Programme is working with the IMF, Norway and the World Bank Group. As a result of assistance being provided to the Zambian Revenue Authority, improved transfer pricing legislation and new regulations and transfer pricing documentation rules will be introduced in the near future. Revenue from audits has increased from US$3.22m in 2012 to US$7.91m in 2013.

Botswana, Jamaica, Sri Lanka and Zimbabwe are in the process of introducing revised transfer pricing legislation and regulations aligned with international standards, as well as other administrative changes.

5. Next steps

These results demonstrate that progress is possible and there is growing demand for such programmes in 2016 and beyond.

As these capacity development programmes put the building blocks in place for effective transfer pricing regimes, some of the countries are deploying experts under the *Tax Inspectors Without Borders (TIWB)* initiative to consolidate the impact of the programmes. Ghana, for example, has a TIWB deployment of transfer pricing specialists from The Netherlands tax administration who are working side-to-side with tax administration auditors increasing their knowledge, experience and abilities in this field. Albania, Malawi, Rwanda, Lesotho and Senegal are also benefitting from TIWB deployments working together with the United Kingdom, Italy and France. The Tax and Development Programme is working with the joint UNDP/OECD TIWB Secretariat to offer TIWB to developing countries.

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